

STATE OF MONTANA

Public Employees' Retirement Board

A Component Unit of the State of Montana

Comprehensive Annual Financial Report



**For the Fiscal Year Ended
June 30, 2003**

Public Employees' Retirement System - Defined Benefit Retirement Plan

Municipal Police Officers' Retirement System

Game Wardens' and Peace Officers' Retirement System

Sheriffs' Retirement System

Judges' Retirement System

Highway Patrol Officers' Retirement System

Firefighters' Unified Retirement System

Volunteer Firefighters' Compensation Act

Public Employees' Retirement System - Defined Contribution Retirement Plan

Deferred Compensation (457) Plan

**Prepared By:
The Fiscal Services Bureau
Public Employee Retirement Administration
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INTRODUCTORY SECTION

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Mission Statement of the PERB

The Montana Public Employees' Retirement Board will fiduciarily administer its retirement plans and trust funds, acting in the best interest of the members and beneficiaries.

Mission Statement of the MPERA

The Montana Public Employee Retirement Administration will efficiently provide quality benefits, education and service to help our plan members and beneficiaries achieve a quality retirement.

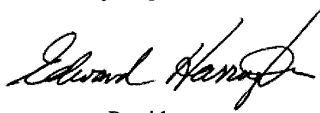
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Montana Public
Employees' Retirement Board,
Montana

For its Comprehensive Annual
Financial Report
for the Fiscal Year Ended
June 30, 2002

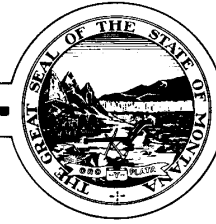
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Reporting is presented by the Government Finance Officers
Association of the United States and Canada to
government units and public employee retirement
systems whose comprehensive annual financial
reports (CAFRs) achieve the highest
standards in government accounting
and financial reporting.




President


Executive Director

PUBLIC EMPLOYEE RETIREMENT ADMINISTRATION



JUDY MARTZ
GOVERNOR

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November 24, 2003

The Honorable Judy Martz
Governor of Montana
Room 204, State Capitol
PO Box 200801
Helena, MT 59620

Dear Governor Martz:

The Public Employees' Retirement Board (PERB) and its staff, the Montana Public Employee Retirement Administration (MPERA), are pleased to submit this *Comprehensive Annual Financial Report* (CAFR) for the fiscal year ended June 30, 2003, in accordance with 19-2-407, Montana Code Annotated. The PERB is a discretely presented component unit Pension Trust Fund of the State of Montana financial reporting entity. For this reason, the financial statements contained in this report are also included in the State of Montana Comprehensive Annual Financial Report.

The Public Employees' Retirement Board administers ten separate retirement plans, each reported in this CAFR. They include the *Public Employees' Retirement System-Defined Benefit Retirement Plan* (in its 59th year of operation) and *Public Employees' Retirement System-Defined Contribution Retirement Plan, Municipal Police Officers' Retirement System, Game Wardens' and Peace Officers' Retirement System, Sheriffs' Retirement System, Judges' Retirement System, Highway Patrol Officers' Retirement System, Firefighters' Unified Retirement System, Volunteer Firefighters' Compensation Act* and the *Deferred Compensation (457) Plan*.

The CAFR is divided into five sections:

- an *Introductory Section*, which contains the table of contents, letter of transmittal, administrative organization and legislative highlights;
- a *Financial Section*, which contains the report of the Independent Auditors, the Management's Discussion and Analysis, the financial statements of the PERB, the notes to the financial statements, certain required supplementary information and supporting schedules of administrative expenses, investment expenses and payments to consultants;
- an *Investment Section*, which contains a report on investment activity, investment policies, investment results and various investment schedules;
- an *Actuarial Section*, which contains the Actuary's Certification Letter and the results of the biennial actuarial valuation; and,
- a *Statistical Section*, which includes significant data pertaining to the plans.

Fiduciary responsibility for the systems rests with the PERB, which consists of seven members, appointed by the Governor. The members are assigned five-year, staggered terms. Responsibility for both the accuracy of the data, and the completeness and fairness of the presentation rests with

INTRODUCTORY SECTION

the MPERA. This CAFR was prepared in conformance with the principles of governmental accounting and reporting set forth by the Governmental Accounting Standards Board, including the Management's Discussion and Analysis (MD&A) located in the front of the Financial Section. The MD&A is a discussion, by management, of the financial position of the retirement plans. Defined benefit and defined contribution transactions are reported on the accrual basis of accounting. Sufficient internal accounting controls exist to provide reasonable assurance regarding the fair presentation of the financial statements, supporting schedules and the safekeeping of assets.

The pages that follow report the facts and figures that are the result of hard work, new initiatives, improved processes and continuing efforts we have made to meet the needs of our customers. We trust that you and the members of the plans will find this CAFR helpful in understanding the retirement plans.

ADDITIONS TO PLAN NET ASSETS

The employer, employee and state contributions, as well as income from investments, provide the reserves needed to finance retirement benefits. Below is a table presenting a comparison of the fiscal year 2003 and 2002 financial data for the defined benefit plans.

<i>Defined Benefit Plans Additions to Plan Net Assets</i>					
	FY2003		FY2002		
				Inc/(Dec) Amount	Inc/(Dec) Percentage
Member Contributions	\$	71,758,079	\$	69,126,435	\$ 2,631,644 4 %
Employer Contributions		72,141,727		69,228,566	2,913,161 4 %
State Contributions		14,503,752		13,800,938	702,814 5 %
Registration Fees		353,589		308,973	44,616 14 %
Retirement Incentive Contr.		404,473		188,962	215,511 114 %
Interest Reserve Buybacks		932,995		163,778	769,217 470 %
Membership Fees		161		167	(6) (4) %
Miscellaneous Revenue		860		596	264 44 %
Investment Income		203,162,525		(240,373,885)	443,536,410 185 %
Totals	\$	363,258,161	\$	(87,555,470)	\$ 450,813,631 515 %

Contributions and investment income for the defined benefit pension trust funds for fiscal year 2003 totaled \$363,258,161. The defined benefit plans are managed on a long-range basis that allows for recovery in years when the market trends decrease. The rates of return for the last 5 years for each plan is still more than a 2.39 percent. This information is available in the *Investment Section* of this annual report.

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License Fees and education contributions have been categorized as employer contributions. Interest reserve buybacks have increased because there have been more mandatory retroactive payments with interest in fiscal year 2003 and due to the interest calculated when members transferred to the DCRP and ORP plans. Retirement incentive contributions have increased due to more employees taking advantage of the Employee Protection Act. Investment income increased in fiscal year 2003 because of the turnaround of the equity market.

Below is a table presenting a comparison of the fiscal year 2003 and 2002 financial data for the defined contribution plans.

<i>Defined Contribution Plans Additions to Plan Net Assets</i>				
	FY2003	FY2002	Inc/(Dec) Amount	Inc/(Dec) Percentage
Member Contributions	\$ 25,114,561	\$ 13,313,925	\$ 11,800,636	89 %
Employer Contributions	6,174,127	46,412	6,127,715	13,203 %
Miscellaneous Revenue	257,067	222,793	34,274	15 %
Nonvested Member Forfeitures	31,188	-	31,188	100 %
Investment Income	<u>9,091,718</u>	<u>(4,430,904)</u>	13,522,622	305 %
Totals	<u>\$ 40,668,661</u>	<u>\$ 9,152,226</u>	\$ 31,516,435	344 %

The defined contribution plans include the PERS-DCRP and the Deferred Compensation (457) Plan. Member contributions increased because of the startup of the PERS-DCRP in 2003 and changes in the federal laws; participants could decide to join and/or decide to transfer other employee retirement plan funds. Employer contributions increased significantly because of the startup of the PERS-DCRP and the transfer of funds to the new DCRP plan. The 457 plan only has one employer that contributes to the plan. For those participants that filed elections at or near the June 30th cutoff date, MPERA has also included in the financial statements adjustments of \$3.5 million to member contributions and \$2 million to employer contributions to reflect the DCRP contributions that actually moved in early fiscal year 2004. Forfeitures are new this year and are associated with the PERS-DCRP plan. Any member that is not vested at the time of withdrawal, forfeits the employer portion of contributions. The forfeited contributions are returned to the MPERA and used to pay administrative expenses of the plan. Investment income increased in fiscal year 2003 because of the turnaround of the equity market. In fiscal year 2003, the contributions and investment income totaled \$40,668,661.

DEDUCTIONS TO PLAN NET ASSETS

The principle purpose for which the pension trust plans were created was to provide retirement, survivor and disability benefits to qualified members and their beneficiaries. The cost of such programs include recurring benefit payments as designated by the plan, refund of contributions to terminated employees, and the cost of administering the plans. On the following page is a table presenting a comparison of the defined benefit plans' fiscal year 2003 and 2002 financial data.

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For the defined benefit plans, total expenses for fiscal year 2003 totaled \$191,685,477, an increase of 19 percent over fiscal year 2002 expenses. Two new categories, Transfers to the DCRP and Transfers to the ORP, were added this fiscal year. This is because members of the PERS-DBRP could choose membership in the PERS-DCRP (or Optional Retirement Plan if they were employees of the university system) and have their contributions transferred accordingly. For those participants that filed elections at or near the June 30th cutoff date, MPERA has also included in the financial statements \$5.5 million to Transfers to DCRP and \$2 million to Transfers to ORP to reflect the DCRP and ORP contributions that actually moved in early fiscal year 2004. Administrative expenses decreased in fiscal year 2003. In fiscal year 2003, revenues of \$363,258,161 exceeded expenses of \$191,685,477 by \$171,572,684.

<i>Defined Benefit Plans Deductions to Plan Net Assets</i>				
	FY2003	FY2002	Inc/(Dec) Amount	Inc/(Dec) Percentage
Benefit Payments	\$ 155,456,469	\$ 145,783,245	\$ 9,673,224	7 %
Member Refunds	11,498,705	11,964,539	(465,834)	(4) %
Refunds to Other Plans	340,797	438,608	(97,811)	(22) %
Transfers to DCRP	15,990,427	-	15,990,427	100 %
Transfers to ORP	5,957,197	-	5,957,197	100 %
Supplemental Insurance	12,000	12,675	(675)	(5) %
Administrative Expenses	2,429,882	3,531,088	(1,101,206)	(31) %
Totals	\$ 191,685,477	\$ 161,730,155	\$ 29,955,322	19 %

Below is a table presenting a comparison of the fiscal year 2003 and 2002 financial data for the defined contribution plans.

<i>Defined Contribution Plans Deductions to Plan Net Assets</i>				
	FY2003	FY2002	Inc/(Dec) Amount	Inc/(Dec) Percentage
Refunds to Members	\$ 11,277,057	\$ 11,459,674	\$ (182,617)	(2) %
Administrative Expenses	769,559	687,309	82,250	12 %
Miscellaneous Expenses	793,948	810,882	(16,934)	(2) %
Totals	\$ 12,840,564	\$ 12,957,865	\$ (117,301)	(1) %

For the defined contribution plans, total expenses for fiscal year 2003 totaled \$12,840,564, a decrease of 1 percent over fiscal year 2002 expenses. Most of the increase in administrative costs are associated with the implementation of the PERS-DCRP. To implement the plan, it was necessary to ensure that the plan qualifies under federal regulations. Miscellaneous expenses include charges from Allianz, Aegon and Great West Life & Annuity Insurance Co. The decrease in miscellaneous expenses are primarily due to the reduction in charges by Aegon and Great West because of the reduced charges included in the contract. In fiscal year 2003, revenues of \$40,668,661 exceeded expenses of \$12,840,564 by \$27,828,097.

INVESTMENTS

The investments of the plans are governed, primarily, by an investment standard known as the “prudent expert principle.” The prudent expert principle is constitutionally and statutorily mandated and establishes a standard for all fiduciaries, which includes anyone that has authority with respect to the fund. The prudent expert principle states that fiduciaries will discharge their duties solely in the interest of the fund participants and beneficiaries and with the degree of diligence, care and skill which prudent experts would ordinarily exercise under similar circumstances in a like position. By following the prudent expert principle and permitting further diversification of investments within a fund, the fund may be enabled to reduce overall risk and increase returns. A summary of the asset allocation can be found in the *Investment Section* of this annual report.

The prudent expert principle permits the PERB to establish an investment policy based upon certain investment criteria and allows for the delegation of investment authority to the Board of Investments (BOI), Department of Commerce. The statement of investment policy outlines the responsibility for the investment of the funds and the degree of risk that is deemed appropriate for the funds. Investment officers are to execute the investment policy in accordance with statutory authority, the PERB’s policy and their respective guidelines, but are to use full discretion within the policy and guidelines. For fiscal year 2003, the Public Employees’ Retirement System’s (PERS) total rate of return on investments was 6.61 percent. The PERS rate of return over the last three years has averaged a negative 2.07 percent per year and 2.60 percent over the last five years.

FUNDING

Pension funds are well-funded when there is enough money in reserve to meet all expected future obligations to participants. The PERB’s funding objective is to meet long-term benefit promises through contributions that remain approximately level as a percent of member payroll. The greater the level of funding, the larger the ratio of assets accumulated to the actuarial accrued liability and the greater the level of investment potential. The advantage of a well-funded plan is that the participants can see assets that are committed to the payment of benefits. A detailed discussion of funding is provided in the *Actuarial Section* of this annual report beginning on page 103.

ECONOMIC CONDITION AND OUTLOOK

The economic outlook of the plans is based primarily upon investment earnings. For 2003, the PERS experienced a 6.61 percent fair value rate of return, for the last three years an average annualized rate of return of a negative 2.07 percent and for the last five years an average annualized rate of return of 2.60 percent. The plans are required by law to be maintained on an actuarially sound basis as certified in this report by our actuary, thus protecting participants’ future benefits. The previous bear market has negatively affected earnings, but we anticipate that over the long-term and as the market continues to recover, our earning rates will continue to meet our actuarial assumed earning rates. Current member benefits will not be changed, although the legislature will review the funding and assure the plans are funded on an actuarially sound basis. Based on the report of our actuary, two of the

INTRODUCTORY SECTION

eight defined benefit plans had surplus funding as of June 30, 2002.

The PERS-DCRP was implemented July 1, 2002. Members had the opportunity to choose membership in either the defined benefit retirement plan (DBRP) or the defined contribution retirement plan (DCRP). University employees also had the option of joining the Optional Retirement Program (ORP) administered by the Teachers Insurance and Annuity Association - College Retirement Equities Fund (TIAA-CREF New York, NY). New hires of the PERS are now exercising their option of choosing the retirement plan in which they wish to belong.

Education is funded by a percentage of employer contributions from the PERS-DBRP. The Board is required to educate members and employers of the PERS about the options and benefits of the DCRP and the DBRP. The education campaign is also to prepare new members to make an informed decision about choosing the most appropriate plan for their personal situation.

The MPERA has implemented a web reporting system. The advantage of using advanced technology results in more accurate reporting and more timely deposits to participants' accounts. As of July 1, 2003, all payrolls must be reported within five working days of each payday.

PROFESSIONAL SERVICES

The PERB contracts with consultants for professional services that are essential to the effective and efficient operation of the plans. Opinions from the Independent Auditors and the actuary are included in this report. The FY2002 valuation was performed by the PERB's actuary, Milliman U.S.A.

Some outside consultants contracted by the PERB are: Educational Technologies, Inc., Computer Consulting Corporation, Milliman U.S.A., Arnerich Massena & Assoc., Inc., BearingPoint, Communications & Management Service, Lawrence R. McEvoy, M.D., and William M. Mercer, Inc. Others include the Legislative Audit Division, the Department of Justice Legal Services Division and the Professional Development Center. A schedule of consultants appears on page 78.

CERTIFICATE OF ACHIEVEMENT

The Government Finance Officers Association of the United States and Canada (GFOA) awarded a Certificate of Achievement for Excellence in Financial Reporting to the Montana Public Employees' Retirement Board for its comprehensive annual financial report for the fiscal year ended June 30, 2002. This was the fifth consecutive year that the Montana Public Employees' Retirement Board has achieved this prestigious award. In order to be awarded a Certificate of Achievement, a government must publish an easily readable and efficiently organized comprehensive annual financial report. This report must satisfy both generally accepted accounting principles and applicable legal requirements.

A Certificate of Achievement is valid for a period of one year only. We believe our current comprehensive annual financial report continues to meet the Certificate of Achievement Program's requirements and we are submitting it to the GFOA to determine its eligibility for another certificate.

INTRODUCTORY SECTION

ACKNOWLEDGEMENTS

The compilation of this report reflects the efforts of the staff of the Montana Public Employee Retirement Administration. This report is intended to provide complete and reliable information as a basis for making management decisions, as a means of determining compliance with legal provisions, and as a means of determining responsible stewardship of the funds of the plans.

The reporting employers of each retirement system form the link between the plans and the members. Their cooperation contributes significantly to the success of the plans. We hope the employers and their employees find this report informative.

On behalf of the PERB, we would like to take this opportunity to express our gratitude to the staff, the advisors and the many people who have worked so diligently to assure the successful operation of the plans.

Respectfully submitted,

Signature on File

Michael O'Connor, Executive Director
Montana Public Employee Retirement Administration

Signature on File

Terry Teichrow, President
Public Employees' Retirement Board

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Public Employees' Retirement Board

A Component Unit of the State of Montana



N. Jay Klawon
Hamilton
Investment Management
Experience
Investment Representative,
Edward Jones
Term Expires 3/31/2004



Carole Carey, Vice Pres.
Ekalaka
Active Member
Clerk of District Court
Carter County
Term Expires 3/31/2007



Jim Pierce
Livingston
PERS DCRP Member
Computer Technician/
Employment Consultant
Bozeman Job Service
Term Expires 3/31/2008



Terry Teichrow, President
Helena
Active Member
Education Specialist
Office of Public Instruction
Term Expires 3/31/2005



Betty Lou Kasten
Brockway
Private Citizen
Rancher
Term Expires 3/31/2006



Troy McGee
Helena
Retired Public Employee
Term Expires 3/31/2008

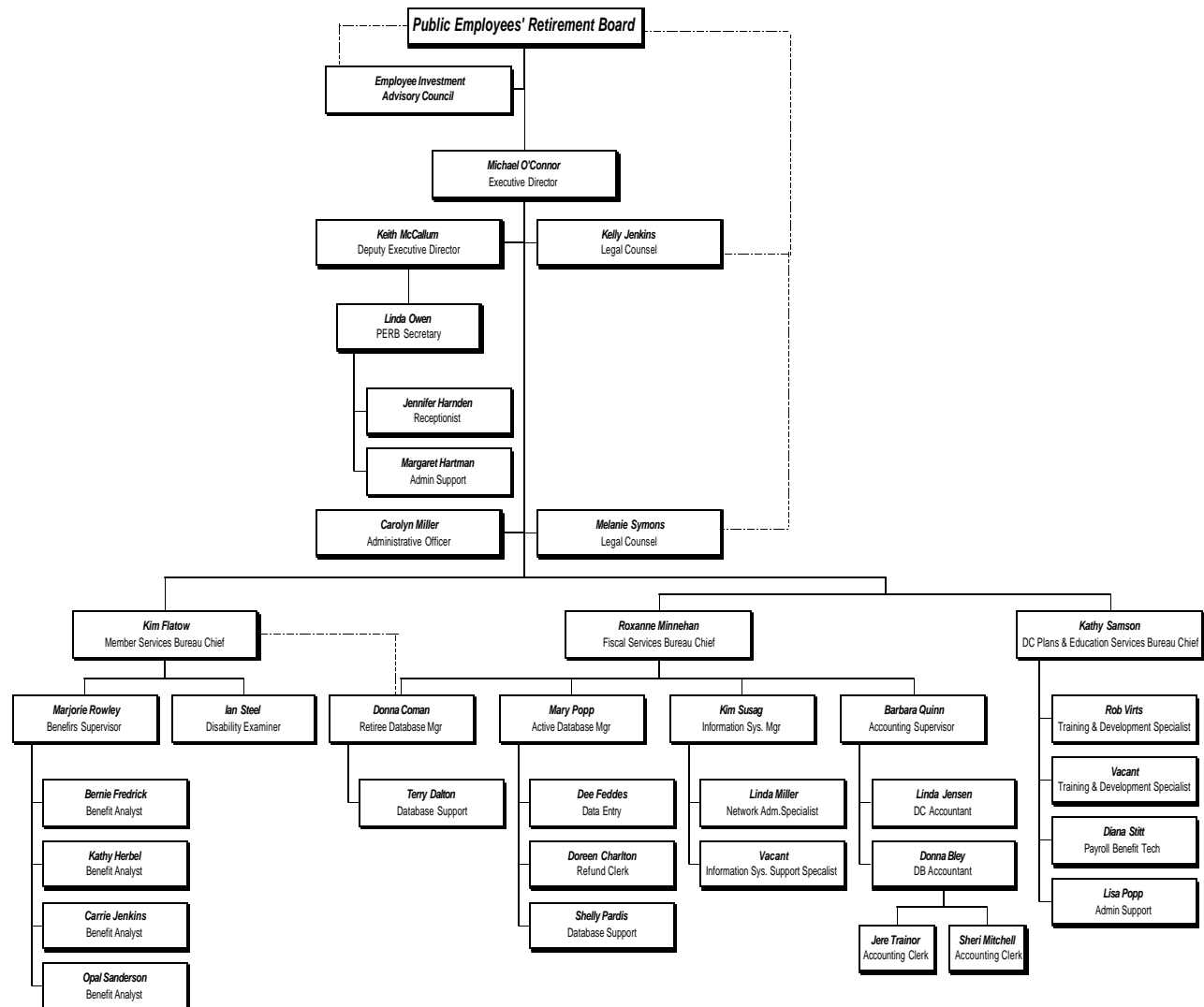


Robert Griffith
Helena
Private Citizen
Term Expires 3/31/2008

Public Employee Retirement Board

A Component Unit of the State of Montana

MPERA Organizational Chart



INTRODUCTORY SECTION

Public Employees' Retirement Board

A Component Unit of the State of Montana

2003 Legislative Highlights

Purchase of Service as a Volunteer in a U.S. Service Program for PERS - Senate Bill 145

Effective October 1, 2003, PERS members with at least five years of membership service may now purchase up to five years of the member's service as a volunteer in various United States service programs. The years of service which may be purchased is limited to five years in combination with certain other service purchases.

Optional Retirement Membership for PERS - Senate Bill 110

Effective April 17, 2003, this legislation revises and clarifies options for state and local elected officials to choose or decline membership in a PERS-covered elected position. This legislation provides for:

- Active PERS members who are also serving in a local elected position on the effective date of this legislation have a retirement membership option. They may, by January 1, 2004, decline their PERS membership in the elected position if they will work less than 960 hours in that position in a calendar year.
- A PERS member who is elected to a local government position after the effective date of this legislation may, within 180 days of being elected, decline optional membership in their elected position. Membership may be declined only if they will work less than 960 hours in the elected position in a calendar year.
- Retired PERS members elected to a local or state PERS-covered position may choose to become an active member or decline the membership for the elected position. This applies to members receiving a retirement benefit under the defined benefit retirement plan or a distribution under the defined contribution retirement plan.
- Retired PERS members in a local or state elected position who decline the optional membership are not subject to the hour or earning limitations for working retirees.

Deferred Retirement Option Plan for MPORS - House Bill 686

The MPORS Deferred Retirement Option Plan (DROP) was implemented July 1, 2002. The DROP revisions are effective April 9, 2003. This legislation allows MPORS members who complete at least 20 years of membership service, at any age, to participate in the DROP. Members may also retroactively elect the DROP if they attained their 20 years of membership service between July 1, 2002 and June 30, 2003. To receive credit retroactively to the date between

INTRODUCTORY SECTION

July 1, 2002, and June 30, 2003, when they would have been eligible to participate in the DROP, the member must have made this election on or before October 1, 2003.

Potential Increase Retirement Benefit for Volunteer Firefighters Compensation Act (VFCA) – House Bill 731

Effective July 1, 2003, this legislation increases pension benefits for VFCA members who continue to work after the date they would qualify for a full pension benefit. An **active** VFCA member who is at least 55 years of age and has at least 20 years of service will be able to increase their future pension benefit by \$7.50 for each additional year of service earned after July 1, 2003. Any service earned over a total of 30 years does not apply. Also, service earned prior to the effective date of this legislation, July 1, 2003, may not be used to increase the pension benefit.

Purchase of Military Service for All Systems - House Bill 44 and Senate Bill 66

Effective July 1, 2003, these enactments allow defined benefit retirement system members with at least **five years of membership service** to purchase military service. By law, the amount of service that may be purchased is limited to five years in combination with certain other service purchases.

Generally Revise Public Retirement Law for All Systems – House Bill 213

Each legislative session, the Board submits proposed amendments to revise the statutes for the public retirement systems it administers. The 2003 housekeeping and general revisions bill, HB 213 is effective July 1, 2003. Interpretation of state and federal law and court decisions require constant changes in the public retirement systems. The legislation refines the retirement systems, improves member benefits, and makes the law easier to understand. Most of the amendments in this legislation change the language and terminology, clarify definitions, use terms with more precision and consistency, and simplify administration of the retirement systems. A summary follows:

Purchase of Reserve Military Service

Eligible members of the PERS, HPORS, SRS, GWPORS, MPORS, and FURS, with at least **five years of membership service** may now purchase up to five years of the member's reserve military service. The years of reserve military service that may be purchased is limited to five years in combination with certain other service purchases.

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Disability Benefit Cap Increased

The disability retirement benefit cap for members who became disabled in the line of duty for HPORS, SRS, GWPORS, and MPORS was limited to one-half the member's highest average compensation regardless of the member's length of service. This cap is now lifted for members of these retirement systems with 20 years or more of membership service who become disabled in the line of duty after July 1, 2003. These members will receive a disability retirement benefit equal to 2.5% of their highest or final average compensation (depending on the system) for each year of service credit.

Beneficiary Designation Changes for all systems

Members of all retirement systems may now designate their estate as a beneficiary, in addition to natural persons, charitable organizations, or trusts for the benefit of natural living persons.

Clarification is also made regarding payments if either statutory or designated beneficiaries predecease the member or payment recipient. The predeceased beneficiary's share will be paid to the remaining beneficiaries in amounts proportional to their original share.

Note: None of the above changes affect the required statutory beneficiary designations in MPORS, HPORS, and FURS.

Changes to Options for Retired PERS Members

PERS members retiring after October 1, 1999, and choosing Option 2 or 3 have, under limited circumstances, been allowed to revert to the retirement benefit available to them at retirement. Now these members may either revert to their original retirement benefit or elect a different option and name a different contingent annuitant. Changes to options may be made under two circumstances:

- ◆ The original contingent annuitant dies.
- ◆ The member and the contingent annuitant divorce and an approved Family Law Order does not restrict the member's right to make the change.

Note: Any retirement benefit option change must be filed with the MPERA, **in writing, within 18 months** of the death of or divorce from the contingent annuitant.